BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Accounting for Judgments and Other Costs Associated With Litigation	)	CC Docket No. 93-240

REPLY COMMENTS OF
SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company (SWBT), by its attorneys, files this Reply to Comments filed in response to the Federal Communication Commission's (Commission) Notice of Proposed Rulemaking[1] regarding changes in accounting for litigation costs, including adverse judgments and settlements.

The NPRM proposes a change in the traditional standards for determining whether an expense should be included in the cost of service for ratemaking purposes. The Commission has traditionally recognized that "good faith is presumed on the part of a carrier's management" and "public utility commissions should not substitute their judgments as to the reasonableness of expenditures in the absence of a showing of inefficiency or improvidence."[2] Thus, the general rule is that reasonable litigation costs incurred in good faith must be included among the

[1]In the Matter of Accounting for Judgments and Other Costs Associated with Litigation, CC Docket 93-240, Notice of Proposed Rulemaking (Released September 9, 1993). (NPRM).

[2]In the Matter of Policy to be followed in the Allowance of Litigation Expenses of Common Carriers in Ratemaking Proceedings, CC Docket 79-19, 91 FCC 2d 140, 144 (1982), (1982 Litigation Cost Order) citing Southwestern Bell Telephone Co. v. Public Service Commission of Missouri, 262 U.S. 276, 288-89 (1922); West Ohio Gas Co. v. Public Utilities Commission of Ohio, 294 U.S. 63, 74 (1934). See, Comments of SWBT, pp. 5-7.

utility's operating costs in computing a fair return.[3] The NPRM proposes to ignore these standards, established by the United States Supreme Court and accepted by the Commission at least until 1986, and adopt a standard that expenditures will be presumptively disallowed based solely on the outcome of litigation or the amount paid in settlement of litigation. As the United States Circuit Court of Appeals has recognized, the proposed presumptions of below the line treatment are a "radical departure from past practice."[4]

SWBT and all other commentors, except MCI Telecommunications Corporation (MCI) and Scott J. Rafferty, oppose the presumptions proposed in the NPRM.[5] The majority of commentors note that the rules and presumptions should be rejected because they:

1. constitute an unwarranted and unjustified departure from traditional judicially recognized ratemaking standards previously followed by the Commission,[6]
2. are unnecessary,[7]

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[3]West Ohio Gas Co., 294 U.S. at 74.

[4]See, Mountain States Telephone and Telegraph Co. v. Federal Communications Commission, 939 F.2d 1021, 1035 (D.C. Cir. 1991), (Litton Decision).

[5]See generally, Ameritech Comments; Bell Atlantic Comments; BellSouth Comments; Comsat Corp. Comments; Comments of Pacific Bell and Nevada Bell; NYNEX Comments; USTA Comments; U S WEST Comments. Pacific Bell and Nevada Bell concur, without explanation or rationale, in the NPRM's proposal to record adverse federal antitrust and similar state antitrust litigation judgments in nonoperating accounts, but oppose all other aspects of the NPRM proposals. NYNEX concurs in recording federal antitrust judgments and federal antitrust non-nuisance value post-judgment settlements in nonoperating accounts, but opposes all other aspects of the NPRM proposals.

[6]BellSouth, pp. 5-10; Comsat, pp. 1-4; SWBT, pp. 5-12.

[7]BellSouth pp. 10-17; USTA, pp. 12-18; Ameritech, pp. 3-4; Bell Atlantic, pp. 1-2; SWBT, pp. 3-5.

3. fail to recognize that litigation expenses are normal operating expenses,[8]
4 fail to properly take into account the D.C. Circuit's Litton Decision,[9]
5. fail to take into account the adverse impact of various artificial incentives they create in the litigation process,[10]
6. are contrary to Generally Accepted Accounting Principles[11], and
7. are based on false assumptions.[12]

The only commentors to file in general support of the NPRM were Scott Rafferty, a disgruntled former employee of NYNEX, and MCI. MCI's support of the NPRM is not unexpected--MCI would appreciate and support any proposal which imposes burdensome requirements on affected carriers making it more difficult for such carriers to prove cost of service.

I. THE COMMISSION SHOULD REJECT MCI'S ARGUMENTS FOR A CONCLUSIVE PRESUMPTION AND FOR THE COMMISSION TO BECOME THE ENFORCER OF ALL FEDERAL STATUTES.

MCI contends that the "Commission should presume **conclusively** that violations of federal law are not in the public interest".[13] MCI's position would not allow a carrier the opportunity to demonstrate that the expenses should be included in

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[8]U S WEST, p. 8; Ameritech, p. 3; PacTel, pp. 11-13; SWBT, pp. 26-27.

[9]U S WEST, pp. 2-4; USTA, pp. 3-12; NYNEX, pp. 3, 6-7; SWBT, pp. 7-8.

[10]BellSouth, pp. 21-24; Comsat, pp. 13-20; USTA, pp. 22-24; SWBT, pp. 15-19, 22-26.

[11]U S WEST, pp. 9-11; Bell Atlantic, p. 3; BellSouth pp. 11-13; NYNEX, pp. 14-16; SWBT, pp. 20-22.

[12]BellSouth, pp. 36-38; Comsat, pp. 20-24; USTA, pp. 29-30; SWBT, pp. 12-14.

[13]MCI, p. 2. (emphasis added).

the cost of service, something not proposed by the Commission. MCI's proposed conclusive presumption would be confiscatory and beyond the Commission's power. MCI states that without their proposed presumption, carriers would have "no economic incentive to obey federal statutes."[14]

MCI apparently assumes that the proper role of the Commission is that of enforcer of all federal laws, a view that the Courts and the Commission have consistently rejected. The Circuit Court of Appeals for the District of Columbia, in overturning rules similar to those proposed in the NPRM, noted that Congress has not expressly given the FCC power, particularly its ratemaking power, to deter violations of federal statutes generally.[15] Likewise, the Commission noted in the same appeal that it "does not enforce the vast majority of federal statutes and has no office in the deterrence of such conduct."[16]

MCI's contention that a carrier will have no economic incentive to obey federal statutes without a presumption of disallowance ignores reality. As SWBT notes in its Comments, if an environment existed where the law was undeniably clear, there were no criminal penalties, there was a 100% guarantee of 100% recoverability in a rate case and no adverse publicity that would negatively affect a carrier's stock price and lower consumer

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[14]MCI, p. 4.

[15]Mountain States Telephone and Telegraph Co. v. Federal Communications Commission, 939 F.2d 1035, 1044 (D.C. Cir. 1991).

[16]Brief of Respondents, p. 28, Mountain States Telephone and Telegraph v. Federal Communications Commission, 939 F.2d 1035 (D.C. Cir. 1991).

confidence in the company the argument might have merit.[17] Such an environment never has existed and if it did, MCI's arguments would be applicable to all carriers the Commission regulates--including MCI. To follow MCI's absurd assumption, every corporation in America would have no economic incentive to follow the law because the costs could be passed on to the customers in the form of higher prices. The simple fact remains that Congress is responsible for enacting laws, including setting the range of penalties which deter violation of such laws. The stigma of a statutory violation and the effect it has in the public confidence in a company are direct economic incentives to follow the law in addition to the penalties set by Congress. Finally, contrary to MCI's assumption, employees would find incarceration a direct economic incentive to obey the law.[18]

II. THE COMMISSION SHOULD NOT REQUIRE SETTLEMENTS TO BE BOOKED BELOW-THE-LINE.

MCI attempts to add further regulatory burdens on carriers and waste additional Commission resources by proposing that all settlements be placed in a nonoperating account, with the burden on the carrier to show in separate proceedings that "the settlement was in the public interest."[19] As noted throughout the comments filed in this docket, and the cases and authority cited therein, the fact that a party settles a suit must not be

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[17]SWBT, pp. 13-14.

[18]See, 15 U.S.C. §§ 1, 2, 13, 77, 78 (1993).

[19]MCI, p. 7.

interpreted as a finding of guilt.[20] MCI's proposal that all settlements be subject to a separate proceeding to determine inclusion in the cost of service would discourage settlements and create significant resource and economic burdens on both the carriers and the Commission. As demonstrated by Alascom's attempt to follow the Commission's previous rules regarding recovering settlement costs which exceeded nuisance value, the process is very fact-intensive and resource consuming.[21] MCI's proposal to subject every settlement to this resource intensive and costly process should be rejected.

MCI claims the Commission, by adding a nuisance value exception, is attempting to create an incentive for carriers to settle lawsuits early because "early settlement would be in the interest of the ratepayers because the amount to be recovered from ratepayers would undoubtedly be smaller than the amount required to fully litigate the case".[22] MCI supports the alleged "settle early" approach and argues that if the Commission is going to impose a nuisance value, it should be a very low dollar amount.[23]

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[20]SWBT, pp. 14-15; Comsat, pp. 14-15; Pacific Bell and Nevada Bell, pp. 5-8; BellSouth, pp. 28-31.

[21]In Re: Alascom, Inc. Request for Ratemaking Recognition of an Antitrust Settlement, Memorandum Opinion and Order, DA 90-115, February 2, 1990; Memorandum Opinion and Order, DA 91-179, June 24, 1991.

[22]MCI, p. 8.

[23]MCI, p. 9.

MCI's support of the "settle early" approach demonstrates the inherent problem with the NPRM's proposed presumptions--the adverse incentives it imposes in the litigation process.[24]

As the United States Circuit Court of Appeals and the majority of the commentors note, requiring non-nuisance value settlements to be recorded below the line creates adverse incentives in the litigation process.[25] Accepting MCI's proposal to base "nuisance value" on a set "low dollar amount" would result in even greater adverse incentives. MCI's "settle early" claim completely ignores issues such as whether the lawsuit is frivolous, whether the action of the carrier was in good faith, whether adequate discovery has occurred to put the true facts of the case in focus, whether the legal issues have been determined through motions to dismiss or motions for summary judgment or whether legitimate defenses to the claim are present. MCI's proposal would make it advantageous for carriers to: (1) settle frivolous lawsuits for the "low dollar amount" proposed by MCI, thus encouraging similar suits or (2) refuse to settle cases which could be settled for less than the cost of continued litigation but are above the "low dollar amount" and instead litigating the case to completion with the costs being borne by the ratepayers if successful. Under either scenario the ratepayer loses. As noted in the various comments, settlements should not be placed in below-the-line accounts.[26]

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[24]See, Mountain States Telephone, 939 F.2d at 1046-47; Comsat, pp. 16-17; USTA, pp. 22-24; BellSouth pp. 21-24; SWBT, pp. 15-19, 22-26.

[25]Id.

[26]U S WEST, pp. 8-9; BellSouth, pp. 28-29.

III. THE NPRM PROPOSALS ARE FUNDAMENTALLY UNFAIR TO SHAREHOLDERS AND CONTRARY TO FUNDAMENTAL ACCOUNTING PRINCIPLES.

As even MCI admits, the Commission must balance the interests of the ratepayers with the interests of the shareholders of the regulated carriers.[27] The rules proposed in the NPRM encode a systematic bias against a carrier's shareholders regardless of the outcome of the litigation. As noted in the comments, there is not always a clear bright line between conduct viewed as healthy competition and that which might later be deemed to violate the antitrust laws.[28] The proposed presumptions put all risk of the carrier's employees conduct on the shareholder--by looking only at the outcome of litigation, not the good faith of the employee or company. Further, the proposed rules require litigation costs be placed in a balance sheet account which is not included for ratemaking purposes, thus requiring the shareholders to carry the cost of the litigation until the case is ultimately decided.

The Commission should not require litigation costs to be taken to a balance sheet deferral account where they would not be included in the cost of service. As noted by the majority of commentors, this method is contrary to GAAP, a fact which the Commission itself has recognized in previously rejecting the proposal.[29] The Commission should not reverse its decision entered

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[27]MCI, p. 2.

[28]BellSouth, pp. 24-28; Comsat, pp. 13-16; USTA, pp. 17-18.

[29]Notice of Proposed Rulemaking to Amend Part 31 Uniform System of Accounts for Class A and Class B Telephone Carriers to Account for Judgments and Other Costs Associated with Antitrust Lawsuits and Conforming Amendments to Annual Report M, Report and Order,

in 1986, that the balance sheet deferral method should be rejected as being administratively burdensome and inconsistent with fundamental accounting principles.[30]

IV. THE PROPOSED RULES ARE CONTRARY TO SOUND RATEMAKING POLICY.

Until the price cap sharing mechanism is eliminated, the proposed accounting rules would cause potential irreparable harm to price cap local exchange carriers (LECs). As other commentors have noted,[31] because legitimate operating costs are deferred and "not recognized in the year they are incurred, the proposed rules could drive a carrier's rate of return into the sharing range or increase the amount of the sharing obligation," due to the absence of the expenses in the calculation.[32] Thus, the proposed rules would force some price cap LECs to reduce price cap indexes even though the litigation expenses represent a legitimate cost of doing business. Because legitimate costs would not be recognized in the year they occurred, the price cap sharing obligations that may remain[33] would be overstated.[34] As BellSouth notes, "conversely in

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2 FCC Rcd 3241, 3247 (1986) (1986 Litigation Cost Order); recon., 4 FCC Rcd 4092 (1989) (1986 Litigation Cost Recon. Order) (collectively 1986 Litigation Costs Proceeding); see fn. 11 supra.

[30]1986 Litigation Cost Order, 2 Fcc Rcd. at 3247.

[31]BellSouth, p. 14; See also, Bell Atlantic, pp. 2-3; NPRM, para. 7.

[32]BellSouth, p. 14.

[33]The elimination of the price cap sharing mechanism will be a subject for debate within the LEC price cap performance review that will occur during 1994. When the interstate price cap sharing mechanism is eliminated, the detrimental effects of the proposed rules on the interstate operations of the price cap LECs is eliminated. However, detrimental effects would still persist for

the year in which a lawsuit is resolved favorably to a price cap LEC, many years of deferred litigation costs may be recognized, thereby reducing or eliminating a sharing obligation in that period."[35] As long as carriers are regulated based on their achieved rate of return, any rules that eliminate legitimate expenses from the regulated cost of service without just cause are arbitrary and capricious.

V. CONCLUSION.

For the reasons stated herein and in SWBT's initial comments, the rules proposed in the NPRM should be rejected.

Respectfully submitted,

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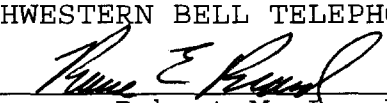
By 

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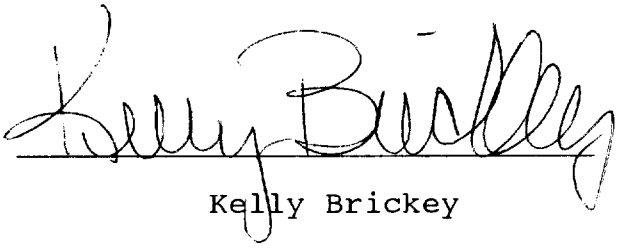
those carriers and in those intrastate jurisdictions regulated under rate of return regulation or some hybrid rate of return regulation plan.

[34]BellSouth, p. 14.

[35]BellSouth, pp. 14-15.

CERTIFICATE OF SERVICE

I, Kelly Brickey, hereby certify that the foregoing "Reply Comments of Southwestern Bell Telephone Company" in CC Docket 93-240, has been served this 5th day of November, 1993 to the Parties of Record.



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